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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1870

E.I. DU PONT DE NEMOURS AND COMPANY, ET AL., *Petitioners,*

v.

RICHARD J. COLLINS, JR., ET AL., *Respondents.*

No. 75-1872

SECURITIES AND EXCHANGE COMMISSION, *Petitioner,*

v.

RICHARD J. COLLINS, JR., ET AL., *Respondents.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF OF PETITIONERS E. I. du PONT de NEMOURS AND COMPANY AND CHRISTIANA SECURITIES COMPANY

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Respondents contend that the Commission's approval of the terms on which Du Pont and Christiana propose to merge should be set aside on essentially three grounds. (1) They read Section 17(b) of the Investment Company Act as requiring that the merger

terms reflect the market value of Christiana common stock and that there be a finding by the Commission that the terms carry the earmarks of an arm's length bargain. (2) They claim that fairness requires that the merger terms allocate to the stockholders of Du Pont a substantial portion of any benefits that accrue to the Christiana stockholders through the operation of the federal tax laws. (3) Respondent Murtaugh also asserts that the Commission should have disapproved the merger because of his apprehension that the merger would cause such selling as to have an adverse impact on the market price of Du Pont stock.

Section 17(b) does not impose the requirements perceived by respondents, and there is no valid basis for rejecting the Commission's informed reasoned judgment as to sharing of tax benefits and alleged market impact.

I. THE REQUIREMENTS OF SECTION 17(b)

The emphasis that respondents and the Court of Appeals place upon the market value of the common stock of Christiana reflects a misconception of the proposed merger. Du Pont is not acquiring the common stock of Christiana which, as Respondent Murtaugh recognizes, is "but an aliquot share in a huge block of Du Pont stock with many impediments and barnacles on it" (Br. 45). It is those very impediments and barnacles that result in the common stock of Christiana selling at a discount from the value of the Du Pont stock that Christiana owns. What Du Pont is acquiring in the merger is some 13.4 million shares of its own stock, totally free of the impediments and barnacles that encrust the common stock of Christiana.

The Commission did not overlook the market value of the Christiana common stock. Indeed, one of the five issues it set down for hearing was "whether the terms of the proposed transactions reflect a disproportionate weight given to either the market value or the net asset value of Christiana securities" (A. 36). The Commission determined that in this case, where over 98 percent of Christiana's assets consist of Du Pont common stock, the proper measure of Christiana's contribution to the merger is the value of that stock. The market price of Christiana stock is so importantly influenced by "impediments and barnacles" that will disappear in the merger that it provides no help in valuing Christiana's contribution to the merger.

The relevant statute, Section 17(b) of the Investment Company Act, delegates to the Commission broad responsibility for determining fairness, reasonableness and the absence of overreaching in transactions involving investment companies. Since the early days of the Investment Company Act the Commission has viewed net asset value as the "primary measure of value of an investment company." *Central States Elec. Corp.*, 30 S.E.C. 680, 700 (1949). Here it applied that principle, holding that an investment company "can normally be presumed to be worth its net asset value." (Pet. App. 32a). Since the merger terms called for the "exchange of equivalents" (Pet. App. 9a)[1]—Du Pont will receive some 13.4 million

[1] Murtaugh's argument that the Commission did not so find but was merely characterizing the applicants' contention is wholly unconvincing (Br. 63). The statement itself is not so qualified; it is the Commission's own description of the transaction. Moreover, the entire opinion discloses that the Commission so understood the transaction. Collins acknowledges that the Commission so found (Br. 14).

shares of its own stock for cancellation and will issue in exchange some 13.2 million shares of the same stock —there was no need to look beyond the value of that stock. If Du Pont were giving cash, notes or shares of another company in exchange for Christiana's assets, there might be a valuation problem. Market value, earnings, dividends, book value, growth prospects are all approximations that must of necessity be used in appraising fairness where unlikes are being exchanged, as the Commission recognized (Pet. App. 31a-32a). Neither law nor logic, however, demands that the parties' contributions to this merger—an approximately equal number of shares of Du Pont common stock on both sides—be measured by anything other than the market value of those shares.[2]

The foregoing is not to say that there may not be factors extraneous to the proposed exchange of Du Pont stock for Du Pont stock that the Commission might take into account in determining the fairness of the proposed terms. The Commission gave full consideration to the factors advanced by the respondents —the benefits flowing to the Christiana stockholders and the claim that the merger would engender sales that would have an adverse impact on the market value of Du Pont stock. No resolution of these factors—whether that made by the Commission or advanced by respondents—would lead any support, however, to the contention that Section 17(b) requires that the market value of the Christiana stock be reflect-

[2] The Court of Appeals correctly perceived that the Act requires the Commission to "look to the value given and received by the respective shareholders to a merger" (Pet. App. 58a). It erred in failing to recognize that the value given by the Christiana shareholders should be measured by the 13.4 million shares of Du Pont stock surrendered for cancellation.

ed in merger terms that call for the exchange of an approximately equal number of shares of Du Pont stock.

Respondents' arms length contention wholly ignores the broad delegation of responsibility that Congress has made to the Commission with respect to transactions involving investment companies. In discharging that responsibility the Commission has not been instructed by Congress merely to ascertain whether the proposed transaction "carries the earmarks of an arm's length bargain." *Pepper* v. *Litton,* 308 U.S. at 306-07. The Commission's charter under the Investment Company Act is much more comprehensive. It must determine whether the proposed terms—regardless of the circumstances in which they are bargained —are reasonable and fair and do not involve overreaching on the part of any person concerned. The inquiry prescribed in *Pepper* v. *Litton* is an accepted procedure for detecting unfairness where a court is asked to pass upon a corporate transaction that has been privately bargained. Section 17(b), however, directs that the Commission's involvement be far deeper wherever investment companies are involved. A transaction within the scope of Section 17(b) is absolutely prohibited unless and until the Commission determines from all the evidence that the transaction meets the statutory criteria. As the Commission pointed out, in commenting on the evidence relating to the course of the merger negotiations, it can place no reliance upon such evidence, but must look solely to the results in ascertaining whether the terms are fair, reasonable, and free of overreaching (Pet. App. 35a, fn. 62).

There is no basis in the language of Section 17(b) or in the objective of that Section for suggesting, as

respondents do, that instead of, or in addition to, making the substantive determination specifically called for in Section 17(b) the Commission must also make inquiry as to whether the transaction carries the earmarks of an arm's length bargain. Such an inquiry is wholly redundant where the Commission must itself—wholly free of control or outside influence—determine fairness, reasonableness and the absence of overreaching before approving an otherwise prohibited transaction.

In the face of the findings the Commission has made, the suggestion that its determination is vitiated by the absence of a finding that the transaction carries the earmarks of an arm's length bargain approaches sophistry. The Commission is specifically directed by Section 17(b) to root out "overreaching on the part of any person concerned." Certainly its finding, after inquiry, that such overreaching is totally absent in this transaction affords at least as much—if not greater—protection to the stockholders of both companies than the "earmarks" inquiry that respondents demand. In addition, that inquiry, as is acknowledged by the law review article on which Murtaugh so heavily relies, is directed at determining whether the dominated company has suffered detriment. Brudney and Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 Harv. L. Rev. 297, 309-312 (1974). The Commission made that inquiry and determined that, while significant benefits would flow to Christiana stockholders, the merger would inflict no "detriment on Du Pont or on its stockholders." (Pet. App. 23a, fn. 44). The Court of Appeals found no fault with that determination (Pet. App. 72a, fn. 22).

The Commission quite properly read Section 17(b) as imposing upon it an obligation to prevent either

Christiana or Du Pont from using a strategic position to effect a merger at other than fair value (Pet. App. 24a, 25a). In determining whether the proposed merger terms met the exacting standards of that section, the Commission declined to speculate as to the bargain that might have been arrived at by wholly unrelated parties free to exploit each other's strengths and weaknesses in a manner denied to those within the scope of Section 17(b).[3]

II. SHARING OF TAX BENEFITS

Both respondents contend that fairness requires that the stockholders of Du Pont be allocated a substantial share of the benefits that will accrue to the Christiana shareholders through the operation of the federal tax laws. Resolution of this contention calls for the exercise of an informed judgment based upon administrative experience and expertise. It has been fully considered by the Commission and it cannot be fairly urged that the Commission's determination to the contrary is arbitrary or irrational. That should be the end of the matter. *Securities and Exchange Commission* v. *Chenery Corp.,* 332 U.S. 194, 209 (1947).

The benefits flowing to the Christiana shareholders, which respondents claim must in fairness be diverted in substantial part to Du Pont, constitute no detriment whatsoever to Du Pont or its stockholders. They flow entirely from the operation of the tax laws as

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[3] An arm's length bargain is not necessarily fair to all concerned. *Cf. Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194 (1947). There the Commission, acting under a "fair and equitable" standard, denied equal participation in a reorganization to certain persons who had purchased stock in good faith at arm's length in transactions that were totally free of "fraud or lack of disclosure." 332 U.S. at 197.

passed by Congress and enforced by the Internal Revenue Service. One benefit is that Christiana would no longer be required to pay the intercorporate dividend tax which, as a corporation, it has been paying. That is the only tax saving made possible by this merger. That saving could have been achieved through a liquidation of Christiana without Du Pont's cooperation and Du Pont stockholders could hardly have any valid claim on that saving on the ground that it was achieved through merger rather than liquidation.

In addition, Christiana stockholders will become direct owners of Du Pont stock. If direct ownership were to be accomplished through a liquidation, Christina stockholders would incur a gain or loss for tax purposes, depending upon their basis in Christiana stock, the value of Du Pont stock received upon liquidation, and their taxpaying status.[4] Such direct ownership can be accomplished through a merger without the imposition of any tax, however, because the tax laws view a merger as a change in the form of the stockholder's investment that does not give rise to tax consequences. Achieving direct ownership through merger does not, however, effect a tax savings but merely a tax deferral until such time as the Du Pont stock received in the merger is disposed of. The tax basis in Christiana stock of a Christiana stockholder will carry forward to the Du Pont stock received in the merger. Should a former Christiana stockholder elect to sell the Du Pont stock, a full capital gains tax would then be payable.

[4] Approximately 11 percent of the Christiana common stock is owned by tax-exempt institutions which would incur no tax upon receipt of Du Pont stock under any circumstances (A. 845).

The principal benefit, therefore, that respondents demand be shared with Du Pont stockholders is that accruing to the Christiana stockholders by reason of their direct ownership of the Du Pont shares that Christiana presently owns. Those shares will presumably have a higher market value than the burdened Christiana stock presently owned by a Christiana stockholder. While these benefits are made possible by the tax deferral that Congress has decreed in the case of mergers, they are not, as has been shown, tax savings. In substance the respondents are claiming that a transaction which has been held to be tax-free under the tax laws shall nonetheless be subjected to an exaction in lieu of a tax by operation of the Investment Company Act, and that the amount exacted be turned over not to the United States Treasury but to the stockholders of Du Pont.[5]

The Commission, quite properly, left the administration of the tax laws to the Internal Revenue Service. It concluded that the tax problems that Christiana faced in placing Du Pont stock in the hands of Christinana shareholders did not alter the inherent value of the Du Pont stock owned by Christiana. To have allocated to Du Pont any significant portion of the benefits flowing to the Christiana shareholders as the result of the tax deferral provided by Congress would, in the Commission's view, have divested such shareholders of "intrinsic investment values to which they are legally and equitably entitled" (Pet. App. 36a). Since protection of investment company shareholders

[5] The proposed merger is conditioned upon a determination by the Internal Revenue Service that the transaction will be tax-free to shareholders of Christiana, which determination has been made.

against dilution in the value of their assets is a prime purpose of the Investment Company Act, the Commission's determination, which implements this purpose, can hardly be adjudged arbitrary or irrational. The tax consequences of the proposed merger were matters to be resolved with the Internal Revenue Service, as the Commission viewed the matter; the stockholders of Du Pont "have no property interest in [those] tax problems" (Pet. App. 24a).

No judicial precedent, no provision of the Investment Company Act, no legislative history is cited by respondents for the proposition that Du Pont is required, as a matter of fairness, to share significantly in the benefits that accrue to the Christiana stockholders through operation of the tax laws. Murtaugh relies largely upon the views of Professors Brudney and Chirelstein, *supra*. Their proposal for sharing post-merger benefits, as they acknowledge, does not reflect existing law, but rests on their "reexamination" of the "existing standard of fairness." 88 Harv. L. Rev. at 313. It appears to be limited to situations in which there are discernible benefits to the surviving corporation and does not suggest that tax benefits achieved by individual stockholders should be shared with stockholders of the other party to the merger. Moreover, their effort is to develop an aid to courts in the application of general equitable principles to challenged mergers; they recognize as outside the scope of their effort those instances in which statutes vest specific authority in an agency to oversee merger terms. 88 Harv. L. Rev. at 298. Certainly Section 17(b) of the Investment Company Act is such a statute and the broad responsibility delegated to the Commission makes unnecessary resort to any general standard designed to serve in the absence of statutory control over merger terms.

The factors unique to investment companies, including their valuation on the basis of underlying assets, the overriding Congressional intent reflected in the Act that asset value be protected against dilution, and the Commission's long line of decisions in comparable mergers giving effect to those policies, are all independent grounds for the reasoned decision of the Commission in rejecting a sharing approach here. The record before the Commission, moreover, demonstrated that its long-established policy was reflected in the practices of the financial community.[6] Respondents would thus have the informed judgment of the Commission as to fairness rejected in favor of a notion of fairness that has no basis in the Act or financial practice.

III. ASSERTED ADVERSE MARKET IMPACT

Murtaugh alone contends that the merger terms are unfair because the merger would have an adverse impact on the market price of Du Pont stock.[7] The Com-

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[6] An analysis of ten comparable mergers of investment companies with their operating affiliates showed that net asset value was the uniform basis for the merger terms, notwitstanding substantial benefits to the investment company party to the merger (A. 687-88). Of these mergers, six were subject to Commission approval under Section 17 and four, because the investment company was not required to be registered with the Commission, were not so subject.

[7] Collins has at no time supported this argument. His contention is that Christiana's ability to vote a large block of Du Pont stock has been a continuing detriment to the remainder of Du Pont's stockholders over the years because it has diluted their voting rights. Instead of welcoming the elimination of Christiana which the proposed merger would accomplish, however, Collins demands that a heavy price be exacted from the Christiana shareholders both as compensation for the alleged harm caused in

mission examined the evidence and the arguments in a reasoned analysis, and rejected the claim for these principal reasons.

First, it found that the argument rested on an invalid premise: an analogy to the predictions of market impact made in connection with proposed forced sales of stock in the Du Pont-General Motors divestiture case.

Second, it found no reason to believe that former Christiana stockholders would act in an irrational manner contrary to their own interests to drive down the price of Du Pont stock.

Third, it determined that such occasional short term market effects as it assumed might result from sales engendered by the merger could not properly be taken into account in determining the fairness of the merger terms.

The entire Murtaugh argument rests largely upon the consequences that follow when stockholders are precluded from acting in furtherance of their own best interests and are required to sell in circumstances in which they might otherwise choose not to sell. Thus he points principally to the apprehensions of adverse market impact expressed as to the divestiture order proposed by the Antitrust Division of the Department of Justice with respect to Du Pont's holdings of Gen-

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the past and as a deterrent to others who might in the future contemplate the formation of a holding company (Br. pp. 10-14). Such an exaction as Collins deems fair would almost certainly defeat the merger. The record shows that Christiana was unwilling to accept any greater discount than that reflected in the merger terms (A. 562); the substantial interest in Christiana held by entities that pay no taxes would militate strongly against terms that deprived them of any significantly larger portion of their underlying investment.

eral Motors stock that were found by this Court to be in violation of Section 7 of the Clayton Act (Br. 35-36). That order, however, would have required, under penalty of contempt, sales of substantial volumes of General Motors stock in each year for a period of ten years. It would also have necessitated substantial additional sales by Du Pont stockholders to obtain funds to pay taxes—in cash—at ordinary income tax rates ranging up to 90 percent on the receipt of General Motors stock as dividends over the same ten year period.

As the Commission correctly observed, "the General Motors situation had nothing in common with this one" (Pet. App. 33a, fn. 59). There is no requirement, by court order or otherwise, that a single share of the Du Pont stock to be received by Christiana shareholders be sold, and the merger will be tax-free so there will be no necessity to sell stock to raise money to pay taxes. No Christiana shareholder will be under any compulsion to act at any time other than in his own self-interest.

The record discloses and the Commission found present here a series of considerations all of which strongly suggest that consummation of the merger will not give rise to significant sales of Du Pont stock. The stock is "generally regarded as an issue of prime investment quality"—which is not disputed by Murtaugh (Pet. App. 31a, fn. 55). The essential nature of the investment of former Christiana stockholders will remain Du Pont (Pet. App. 28a) with no need for reappraisal as is the case in most mergers. Most of the Christiana stock is held by long term investors (Pet. App. 32a). None of the directors of Christiana intends to sell or knows of any person with any intention of

selling (A. 565). The Wilmington Trust Company, which in various capacities holds over half of the Christiana stock, has no intention of selling except as may be required in connection with such matters as the settlement of estates (A. 436, 845). Much of the Christiana stock is held at a very low or zero tax basis as the result of the distribution of General Motors stock by Du Pont and Christiana, thus increasing the tax cost of any sale (Pet. App. 14a). About seventy-five percent of the Christiana stock is held by persons regarded as affiliates of Du Pont under the securities laws. Sales by such persons of any significant amounts of stock would have to be accomplished by registered secondary offerings, which the record shows can be and are made at times and in a manner to minimize any adverse market impact (A. 428-9). The heart of the matter is that there is no basis for believing that any Christiana stockholders would "rush off madly to dispose of valuable property for less than its intrinsic worth" (Pet. App. 25a, fn. 46).[8]

The Commission assumed that the merger might engender some selling which might at certain points in time be substantial (Pet. App. 26a). Without attempting, however, to predict the volume of such sales, it concluded that the market behavior of Du Pont stock would be governed by "economic realities and business fundamentals" (Pet. App. 27a). It correctly perceived that "[i]n no way will the Christiana merger detract from either the assets or earning power of

[8] Murtaugh's contention that the mere transfer of ownership of the Du Pont shares presently owned by Christiana to Christiana's 8,000 shareholders will cause a sharp decline in the market price of Du Pont stock (Br. 37) is sheer speculation. It is only the sale or offer to sell of any such shares that can begin to have any effect on market prices.

that business. The fundamentals of the situation will remain as they are." (Pet. App. 28a). For these reasons the Commission declined in the exercise of its informed judgment to permit "transitory market phenomena" to influence the terms of a "fundamental corporate readjustment" or to speculate "about the probable behavior patterns of speculators" (Pet. App. 27a, 30a).

Murtaugh offered no evidence that the merger would repeal the "realities" and "fundamentals" cited by the Commission, render Du Pont stock an undesirable investment in the hands of the present Christiana stockholders, or cause investors to act irrationally with respect to Du Pont stock. Certainly the Commission was amply warranted in determining on the basis of its own considerable experience and expertise that such selling of Du Pont stock as might be generated by the merger would cause no detriment to Du Pont stockholders that can properly be taken into account in assessing the fairness of the proposed merger terms (Pet. App. 26a).

The Murtaugh claim, calling as it does for a prediction of stock market behavior, is surely one to be resolved by the application of "administrative experience" and "appreciation of the complexities of the problem." The Commission's determination, therefore, that the claim lacks substance "rests squarely in that area where administrative judgments are entitled to the greatest amount of weight by appellate courts." It is the "type of judgment which administrative agencies are best equipped to make and which justifies use of the administrative process." *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. at 209.

CONCLUSION

The Commission has made a reasoned determination that the terms of the proposed merger are fair and reasonable and do not reflect overreaching on the part of any person. That determination faithfully discharges the broad responsibility delegated to the Commission in Section 17(b) of the Investment Company Act and constitutes a wholly rational resolution of respondents' tax benefit sharing and market impact contentions. It should be affirmed and the decision of the Court of Appeals reversed.

Respectfully submitted,

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